



KPIT Cummins

STOCK INFO.	BLOOMBERG
BSE SENSEX: 12,709	KPIT IN
	REUTERS CODE
S&P CNX: 3,677	KPIT.BO

20 October 2006

Buy

Previous Recommendation: Buy

Rs450

		YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
		END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
Equity Shares (m)	14.9	3/06A	3,182	326	22.4	12.2	20.1	4.6	26.2	20.3	2.3	15.6
52-Week Range	502/261	3/07E	4,702	505	34.0	51.9	13.3	3.3	29.7	22.8	1.5	9.6
1,6,12 Rel. Perf. (%)	19/0/-11	3/08E	6,193	631	42.4	24.8	10.6	2.6	27.8	22.5	1.1	7.2
M.Cap. (Rs b)	6.7											
M.Cap. (US\$ b)	0.1											

⚡ **Non-Cummins, BFSI revive strongly:** For 2QFY07 KPIT reported revenue of Rs1.14b, up 11.5% QoQ, higher than our estimate of Rs1.11b. The growth was powered by 27% QoQ growth in non Cummins star customers, Cummins grew slower at 5.8% QoQ. BFSI vertical revived strongly during the quarter, growing 37.7% QoQ. EBITDA margins increased 80bp (expectation of 60bp increase) during the quarter due to lower SG&A expenses. Effective tax rate was higher than expected at 12.5% (v/s expected 10.8%). Net profit was up 19.3% to Rs123m v/s expectation of Rs118m.

⚡ **Higher margin business, greater offshore to boost margins in 2HFY07:** Increase in revenue composition from ATS incorporating higher margins, greater offshore composition and improvement in profitability of acquired entities; are expected to improve margins in 2HFY07.

⚡ **Outlook and view:** We continue to remain positive on KPIT as a specialist in the manufacturing and ATS domain. With the sharp revival in non-Cummins and BFSI, we expect robust growth momentum to continue in the future as well. With higher than expected margins in 2QFY07 and Renesas ODC deal, we have upgraded our EPS estimates by 4% to Rs34 and Rs42.4 in FY07 and FY08E respectively. At CMP, the stock trades at 13.3x FY07E and 10.6x FY08E EPS estimates. We reiterate **Buy** with a target price of Rs560 (upside of 24.3% from current levels).

QUARTERLY PERFORMANCE

(Rs Million)

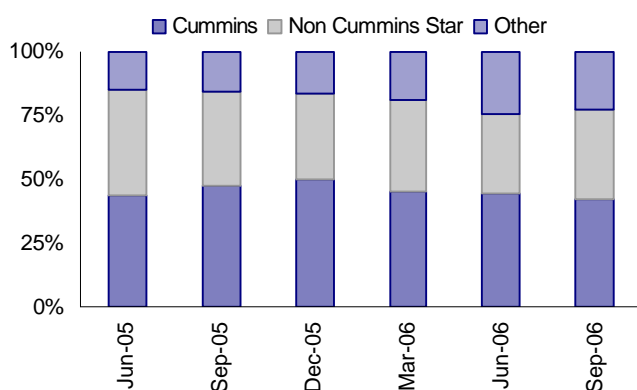
Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Revenues	700	777	804	902	1,023	1,140	1,230	1,310	3,182	4,702
Q-o-Q Change (%)	4.0	11.0	3.5	12.1	13.4	11.5	7.8	6.5	26.0	47.8
Direct Expenses	236	371	402	426	530	577	635	677	1,435	2,419
Sales, General & Admin. Expenses	377	300	286	325	340	384	396	416	1,288	1,536
Operating Profit	87	106	116	150	152	179	199	217	459	747
Margins (%)	12.5	13.6	14.5	16.7	14.9	15.7	16.2	16.5	14.4	15.9
Other Income	4	0	0	0	1	0	1	0	4	2
Depreciation	17	20	22	23	25	30	37	43	82	135
Interest	5	3	5	9	11	7	10	12	23	41
PBT bef. Extra-ordinary	69	83	89	119	117	141	153	162	359	573
Provision for Tax	5	7	6	16	13	18	18	18	33	66
Rate (%)	6.7	7.9	6.8	13.3	11.3	12.5	11.5	11.0	9.2	11.6
PAT bef. MI and EO	64	76	83	103	104	124	135	145	326	507
Minority Interest (MI)					0	0	1	1	0	2
PAT aft. MI and before EO	64	76	83	103	103	123	135	144	326	505
Q-o-Q Change (%)	-14.9	19.2	8.6	24.2	0.7	19.3	9.2	6.4	16.0	55.2
PAT aft. Extra ordinary	64	76	83	103	103	123	135	144	326	505
Q-o-Q Change (%)	-18.3	19.2	8.6	24.2	0.7	19.3	9.2	6.4	14.7	55.2

E: MOSSt Estimates

Non Cummins, BFSI revive strongly in 2QFY07

KPIT reported revenue of Rs1.14b, up 11.5% QoQ, higher than our estimate of Rs1.11b. The growth was powered by 27.1% QoQ growth in non Cummins star customers, who recovered after a few quarters of lackluster growth. The company has upgraded 3 clients to the star customer list (2 from KPIT, 1 from CG Smith), which also contributed to the growth. Cummins grew slower at 5.8% QoQ.

FASTER GROWTH IN NON-CUMMINS BRINGS DOWN CUMMINS' CONTRIBUTION TO REVENUE



Source: Company/ Motilal Oswal Securities

BFSI vertical revived strongly during the quarter, growing 37.7% QoQ due to a revival in some of the top clients in this business, after several quarters of decline. Revenue from BFSI increased to 10.8% from 8.7% in the previous quarter. Inorganic initiatives contributed to 13% during the quarter, growing 22% QoQ. Organic revenue growth was also strong at 10% QoQ. Underlying volume growth (consolidated) was robust at 15% QoQ. Offshore realizations declined by 3.9% due to greater composition of BPO revenue during the quarter. Employee addition was robust at 265, of which 12 were marketing personnel, added during the quarter.

EBITDA margins increased 80bp during the quarter due to lower SG&A expenses during the quarter. Effective tax rate was higher than expected at 12.5% (v/s expected 10.8%). Net profit was up 19.3% to Rs123m v/s expectation of Rs118m.

Renesas ODC - to accelerate growth in Manufacturing

KPIT Cummins has entered into an agreement to set up an ODC with Renesas Technology Corp., one of KPIT's oldest star customers. The ODC will increase the employee base assigned to Renesas to 500 over a period of 3 years from 100 at present. The ODC is one of the largest 3rd party outsourcing agreements for the company and we expect that it would help act as a door opener for further such deals in the semiconductor and automotive segments.

Revival in non Cummins, BFSI, robust client addition - point to strong growth ahead

The highlights of the quarter's results were the pick-up in non-Cummins star customers and the recovery in the BFSI vertical, both led by strong performance in top clients. Given that non-Cummins star customers and BFSI were both dragging down growth in the last few quarters, we expect that a revival in these categories would ensure robust momentum in growth over the forthcoming quarters. Additionally, the increase in US\$1m clients to 16 indicates greater client mining in these accounts.

New client addition has also been encouraging during the quarter, with 4 of the 5 clients added being added for ATS services, which is the higher end, higher-margin business in the Manufacturing vertical. ATS is one of the focus areas for KPIT, and greater growth in this segment could result in faster revenue ramp up and margin expansion.

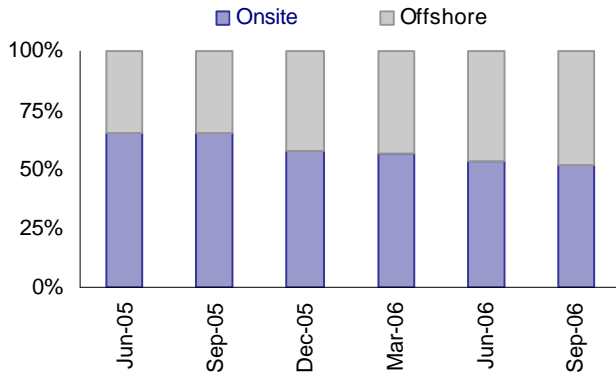
Higher margin business, greater offshore to boost margins in 2HFY07

ATS, currently at 20-22% of revenue, is rapidly gaining traction and the company is targeting 25% of revenue to arise from this business going forward in FY07. Since this is a higher-margin business, increase in revenue composition from ATS is likely to improve overall margins for the company.

Offshore composition is another lever for margin expansion for KPIT. While offshore composition increased to 48% from 46.8% in the previous quarter, we believe there is

room for further improvement from these levels which would also result into SG&A leverage, which would also boost margins in 2HFY07.

IMPROVING OFFSHORE MIX



Source: Company/ Motilal Oswal Securities

Additionally, 2QFY07 was the first quarter wherein subsidiaries were fully integrated. We expect synergies to start accruing from 3QFY07 onwards, which would also improve margins in the second half.

Outlook and view

We continue to remain positive on KPIT as a specialist in the manufacturing and ATS domain. With the sharp revival in non-Cummins and BFSI, we expect robust growth momentum to continue in the future as well. With higher than expected margins in 2QFY07 and Renesas ODC deal, we have upgraded our EPS estimates by 4% to Rs34 and Rs42.4 in FY07 and FY08E respectively. At CMP, the stock trades at 13.3x FY07E and 10.6x FY08E EPS estimates. We reiterate **Buy** with a target price of Rs560 (upside of 24.3% from current levels).

KPIT Cummins: an investment profile

Company description

KPIT Cummins is an emerging niche IT play, with revenues of close to US\$100m expected in FY07. It focuses on the manufacturing vertical, with niche offerings in advanced technology solutions (ATS), business intelligence, and high value added BPO/ITES. It employs over 2,800 people. Its key clients include Cummins, Unilever, Deutsche Bank, Hitachi-Renesas, BNP Paribas Business Objects and HP.

Key investment arguments

- ☞ Credible tier-2 Indian IT services vendor with niche offerings.
- ☞ One of the few Indian IT vendors with specialized focus in Manufacturing - Semiconductor/Automotive space.

Key investment risks

- ☞ Cummins account near maturity; up for renegotiation in FY08. The high growth rates in the Cummins account could taper off, as existing service lines would achieve critical mass.
- ☞ Scalability of the employee base and availability of people with the right skill-sets remains a key constraint. Attrition at +20% is high, which could result in higher wage costs as the company tries to retain employees.

Recent developments

- ☞ Entered into an agreement to set up an Offshore Development Centre for star client Renesas, touted as the largest of its kind.
- ☞ Recently opened a branch in Singapore to target clients in the Asia Pacific region.

Valuation and view

- ☞ Revenue CAGR of 39.5% and earnings CAGR of 39.2% over the next two years.
- ☞ Valuations at 13.3x FY07 and 10.6x FY08 earnings are attractive.
- ☞ Maintain **Buy** with target price of Rs560.

Sector view

- ☞ Various CIO surveys indicate increasing share of offshore spending in IT budgets.
- ☞ Indian offshore vendors gaining market share in competition with MNCs.
- ☞ Prefer large companies as bulk of volumes going to them while niche players benefit due to lack of offshore competition in their segments.

COMPARATIVE VALUATIONS

		KPIT	GEOMETRIC	HEXAWARE
P/E (x)	FY07E	13.3	18.0	18.0
	FY08E	10.6	12.7	14.3
P/BV (x)	FY07E	3.3	3.4	3.0
	FY08E	2.6	2.8	2.6
EV/Sales (x)	FY07E	1.5	2.2	2.2
	FY08E	1.1	1.5	1.6
EV/EBITDA (x)	FY07E	9.6	9.8	13.7
	FY08E	7.2	7.1	10.9

SHAREHOLDING PATTERN (%)

	SEP.06	JUN.06	SEP.05
Promoter	26.1	26.2	27.2
Domestic Inst	18.8	20.5	13.4
Foreign	34.7	31.0	34.5
Others	20.4	22.3	24.9

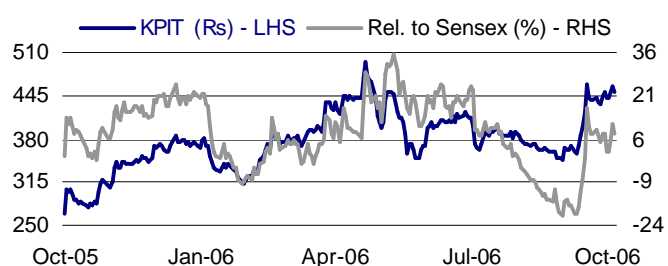
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	34.0	31.0	9.5
FY08	42.4	41.8	1.5

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
450	560	24.3	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)				
Y/E MARCH	2005	2006	2007E	2008E	2009E	
Sales	2,525	3,182	4,702	6,193	7,825	
Change (%)	98.8	26.0	47.8	31.7	26.3	
Software Develop. Exp.	1,665	2,061	2,945	4,006	5,204	
SG&A	526	662	1,010	1,239	1,489	
EBITDA	334	459	747	948	1,132	
% of Net Sales	13.2	14.4	15.9	15.3	14.5	
Depreciation	32	82	135	200	236	
Interest	9	19	41	37	25	
Other Income	1	0	2	3	5	
PBT	294	359	573	715	876	
Tax	13	33	66	79	96	
Rate (%)	4.4	9.3	11.6	11.0	11.0	
PAT	281	325	507	636	779	
Extraordinary items	-3	0	0	0	0	
Minority Interest	0	0	2	5	11	
Net Income	284	326	505	631	769	
Change (%)	96.9	14.7	55.2	24.8	21.9	

BALANCE SHEET		(Rs Million)				
Y/E MARCH	2005	2006	2007E	2008E	2009E	
Share Capital	70	73	74	74	74	
Subs. Money Recd. in Adv.	45	26	26	26	26	
Share Premium	502	577	687	687	687	
Reserves	445	742	1,201	1,773	2,466	
Net Worth	1,061	1,417	1,987	2,559	3,253	
Minority Interest	0	4	6	12	13	
Loans	370	875	1,106	1,006	906	
Deferred tax liability	6	8	13	21	29	
Capital Employed	1,436	2,305	3,113	3,597	4,201	
Gross Block	614	863	1,726	1,876	2,126	
Less : Depreciation	109	190	315	450	453	
Net Block	504	673	1,411	1,426	1,674	
CWIP	33	281	35	150	50	
Curr. Assets	1,173	1,721	2,263	2,704	3,517	
Debtors	501	868	1,322	1,494	2,064	
Cash & Bank Balance	546	411	662	874	1,029	
Loans & Advances	127	442	279	336	423	
Current Liab. & Prov	274	370	597	683	1,040	
Creditors	205	288	435	435	685	
Other liabilities	0	1	0	0	0	
Provisions	69	81	161	247	354	
Net Current Assets	899	1,351	1,667	2,021	2,477	
Application of Funds	1,436	2,304	3,113	3,597	4,201	

E: MOSI Estimates

RATIOS						
Y/E MARCH	2005	2006	2007E	2008E	2009E	
Basic (Rs)						
EPS*	19.9	22.4	34.0	42.4	51.7	
Likely Diluted EPS			33.3	41.6	50.7	
Cash EPS*	22.4	28.1	43.4	56.3	68.2	
Book Value	75.7	97.9	134.5	173.5	220.7	
DPS	18	18	2.8	3.5	4.5	
Payout % (Incl.Div.Taxes)	8.7	7.8	8.1	8.3	8.7	
Valuation (x)						
P/E	22.6	20.1	13.3	10.6	8.7	
Likely Diluted P/E			13.5	10.8	8.9	
Cash P/E	20.1	16.0	10.4	8.0	6.6	
EV/EBITDA	19.5	15.6	9.6	7.2	5.8	
EV/Sales	2.6	2.3	1.5	1.1	0.8	
Price/Book Value	5.9	4.6	3.3	2.6	2.0	
Dividend Yield (%)	0.4	0.4	0.6	0.8	1.0	
Profitability Ratios (%)						
RoE	39.0	26.2	29.7	27.8	26.5	
RoCE	29.2	20.3	22.8	22.5	23.3	
Turnover Ratios						
Debtors (Days)	72	100	103	88	96	
Fixed Asset Turnover (x)	7.8	5.4	4.5	4.4	5.0	
Leverage Ratio (x)						
Debt/Equity Ratio(x)	0.3	0.6	0.6	0.4	0.3	

CASH FLOW STATEMENT		(Rs Million)				
Y/E MARCH	2005	2006	2007E	2008E	2009E	
CF from Operations	318	420	689	880	1,041	
Cash for Working Capital	55	590	83	155	318	
Net Operating CF	263	-169	606	725	723	
Net Purchase of FA	-401	-499	-628	-330	-383	
Net Purchase of Invest.	4	18	0	0	0	
Net Cash from Invest.	-397	-481	-628	-330	-383	
Inc/dec in Equity	429	59	111	0	0	
Proceeds from LTB/STB	104	505	231	-100	-100	
Dividend & Interest Payment	-38	-49	-70	-83	-84	
Cash Flow from Fin.	495	516	272	-183	-184	
Free Cash Flow	-138	-669	-22	396	339	
Net Cash Flow	360	-135	250	212	155	
Opening Cash Balance	186	546	411	662	874	
Add: Net Cash	360	-135	250	212	155	
Closing Cash Balance	546	411	662	874	1,029	

For more copies or other information, contact

Institutional: Navin Agarwal. **Retail:** Manish Shah, Mihir Kothari

Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: inquire@motilaloswal.com

Motilal Oswal Securities Ltd, 3rd Floor, Hoechst House, Nariman Point, Mumbai 400 021

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KPIT Cummins

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|---|----|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |
| 4. Investment Banking relationship with company covered | No |

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